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More Growth with More Income Equality in the Americas: Can Regional Cooperation Help

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A NEW APPROACH

REGIONAL economic cooperation has been a central pillar of the strategies of the world's most successful emerging market regions in East Asia and Europe. For these regions, integration has boosted both growth and income convergence. Cooperation has helped these countries take important but difficult steps on their own reform agendas and expanded the resulting economic benefits.

For the Americas, the high hopes for hemispheric cooperation of ten to fifteen years ago have faded, along with confidence in the region's ability to act collectively to address fundamental economic challenges. The costs are high. Governments struggling to sustain high growth and spread its benefits to large excluded populations have little support from region-wide efforts. The Fifth Summit of the Americas in April 2009 looms as an opportunity and challenge in this context.

This region has tended to view regional economic cooperation only through the lens of trade, but there are other paths. Though further trade liberalization remains important, other policy challenges are emerging as binding constraints on growth. And we have seen that trade alone does not necessarily reduce income inequality. New evidence suggests, in fact, that the region may be in the grip of a growth-inequality trap with causality flowing in both directions. Limits to growth keep inequality high compared to other regions (even with recent progress), while inequality itself constrains growth[1].

For these reasons, it is time for the region to consider new cooperative approaches that help address both growth and inequality challenges in

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1. *See*, for example, Birdsall, De la Torre, and Menezes 2008 and IDB 1999.

pragmatic, politically feasible ways. This paper suggests a concerted effort to target one of the region's most serious problems, the poor microenvironment for businesses, particularly businesses at the bottom of the pyramid. The model outlined here is a regional investment standards agreement—a collective effort to set common standards for key microeconomic policies affecting both domestic and foreign businesses. The aim is to help countries do what most already want to do, avoiding the ideological battles enveloping trade agreements.

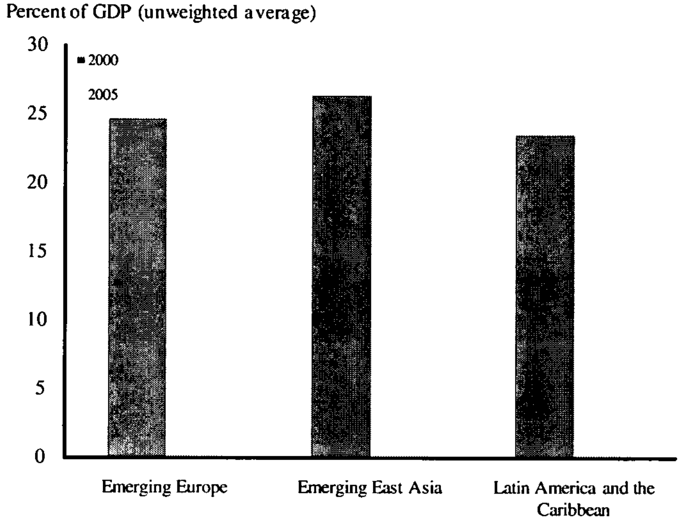
DOES THE REGION STILL HAVE A GROWTH PROBLEM?

Some may question the urgency of forging a regional economic approach after four years of growth averaging above 5 percent in Latin America and the Caribbean, buoyed by good macroeconomic and exchange rate policies, more outward orientation, high commodity prices, and rapid domestic credit growth. Now the deteriorating global economic environment is weighing on regional growth. Growth in Latin America and the Caribbean is predicted to fall by a percentage point to around 4.7 percent in 2008, with a further drop to 4 percent or lower likely in 2009[2].

But troubling weaknesses were already evident during the boom period, when growth remained well below that of emerging markets in Asia and Europe. Despite significant increases in formal employment, an estimated 40 percent of Latin American employment was still in the informal sector in 2006.[3] And the surging exports that ignited recent growth are largely commodities. It is hard to boost productivity growth and sustain robust formal job creation when so much economic activity is outside the legal system and when so much of the export boom consists of energy, minerals, and food. Crucially, Latin America differs from the most successful emerging market regions in a way that bodes ill for the future: investment as a share of gross domestic product (GDP) remains discouragingly low (Figure 1).

2. ECLAC 2008a. Other 2009 growth forecasts for the region are in the neighborhood of 3.5 percent.
3. ILO 2007.

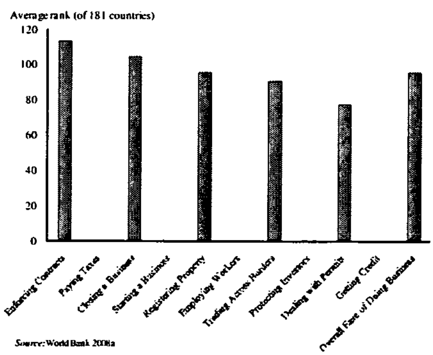
FIGURE 1: GROSS CAPITAL FORMATION, BY REGION, 2000 AND 2005



Source: Author's calculations based on data from World Bank 2007b

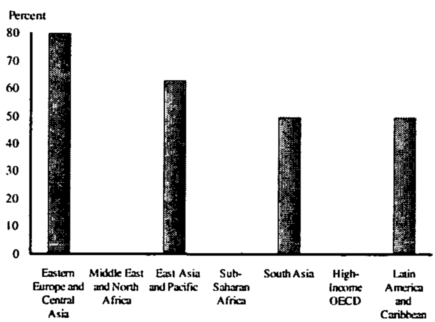
The progress made on some of the traditional barriers to investment and growth in the region[4]—weak macroeconomic policy, financial instability, and high formal trade barriers—has not for the most part been matched in the sphere of microeconomic policies. With some country exceptions, the microeconomic environment for investment remains exceptionally burdensome (Figure 2), while reform efforts lag (Figure 3).

FIGURE 2: BUSINESS CLIMATE INDICATORS FOR LATIN AMERICA AND CARIBBEAN COUNTRIES, 2007/8



Source: World Bank 2008a

FIGURE 3: SHARE OF COUNTRIES MAKING AT LEAST ONE POSITIVE BUSINESS CLIMATE REFORM IN 2007/8



Source: World Bank 2008a

4. Zettelmeyer 2006.

Do businesses worry about microeconomic barriers? Business surveys suggest they do: the top two obstacles cited to doing business in the region are mechanisms for coping with burdensome and non-transparent regulatory and tax systems—choosing to remain in the informal sector and corruption (that is, bribing regulatory and tax officials). If all categories of obstacles associated with burdensome regulation and tax systems are combined, we find that 53 percent of businesses cite these as the main obstacles to doing business in the region (Table 1).

TABLE 1: MAIN OBSTACLES TO DOING BUSINESS IN LATIN AMERICA AND THE CARIBBEAN

	Percent of firms citing problem as main obstacle
Informality*	18.1
Corruption**	11.4
Crime, theft, and disorder	10.9
Political instability	9.9
Access to financing (availability and cost)	9.7
Tax rates	9.1
Electricity	6.9
Skills and education of available workers	6.5
Tax administration	5.1
Labor regulations	4.0
Business licensing and operating permits	3.4
Customs and trade regulations	2.2
Transportation of goods, supplies, and inputs	1.1
Courts	0.9
Access to land	0.8

Note: Shaded categories collectively define obstacles associated with the quality of the regulatory regime and tax systems.

*Covers the extent of informal and underreported operations (which compete with formal enterprises).

**Covers informal payments associated with customs, taxes, licenses, regulations, and government contracts.

Source: World Bank 2006

Microeconomic policies are by no means the only constraint on growth in the region. Poor education, infrastructure quality, and innovation performance also seriously disadvantage the region relative to its rapidly growing emerging market competitors. But these are receiving growing recognition and emphasis. Microeconomic policies often remain the stepchild of the reform agenda.

That is particularly bad news for micro, small, and medium-sized firms. Regulatory and tax problems fall disproportionately hard on them in light of their limited political influence and resources.[5] Attacking these problems would likely help reduce income inequality (which in turn would boost growth) by shrinking informality, aiding newcomers to formal product and capital markets, and boosting the productivity of the poor and near-poor.

5. Birdsall, De la Torre, and Menezes 2008.

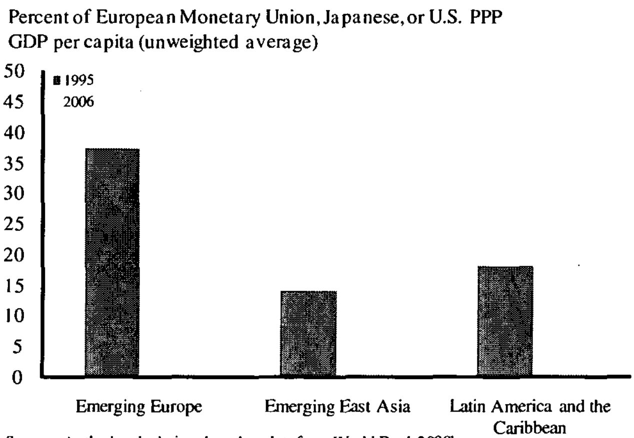
A RACE TO THE BOTTOM?

The stalled race to the top is not the region's only microeconomic policy problem. There are also growing fears of a race to the bottom. One of the forces arrayed against trade agreements in the United States is the concern that harmful tax and regulatory competition gives other countries an unfair competitive advantage over U.S.-based firms and workers[6]. *And in Central America, finance officials already struggle with the fiscal effects of tax holidays aimed at luring foreign investors away from neighboring states. Cooperation to agree on sound common standards would help solve this collective action challenge.*

OTHER REGIONS PULLING AHEAD

While region-wide integration progress in this hemisphere has ground to a halt, other parts of the world have forged ahead rapidly with their own strategies. More than ten countries in emerging Europe have joined the European Union in this decade and reaped striking growth and income benefits. Emerging East Asia is now knit together in cross-border production-sharing chains that are shaped by foreign investment inflows, fed by parts and components trade, and facilitated by governments and regional organizations. For these two regions, integration, especially its benefits for investment, has played a central role in turbo-charging growth and income convergence (Figure 4).

FIGURE 4: INCOME CONVERGENCE, 1995 AND 2006



Source: Author's calculations based on data from World Bank 2008b

Europe boosted investment climates through a top-down, formal enlargement process, with supranational institutions, economic systems reshaped in a common image, and massive aid. In East Asia, the role of governments and regional agreements has been to assist the regional investment

6. Summers 2008.

strategies of private companies through trade facilitation, infrastructure development, and more recently "behind-the-border" reforms. Both approaches offer lessons for this hemisphere, though neither model is easily transferrable. The challenge is to find a third way—one that relies less on bureaucracies, uniformity, and aid than the European Union but that takes a more systematic approach to reform than did East Asia.

A REGIONAL INVESTMENT STANDARDS AGREEMENT

We propose a collective regional effort to set sound and fair standards for improving the quality of regulatory and tax systems. Such standards could simplify and expedite systems for starting a business, paying taxes, obtaining licenses, registering property, dealing with border controls, and accessing credit and infrastructure services. As in the financial world, a standards-based approach could spread good practice without requiring supranational governance (e.g., a common regulator).

In a technical sense, this approach is made possible by the enormous leap forward in the world's capacity to measure the microeconomic environment for investment using objective, verifiable indicators that are consistent across countries and regularly updated by third-party institutions like the World Bank[7]. Examples of such objective indicators range from the official costs of starting a business, to the size of minimum capital requirements for new companies, to the number of procedures to obtain licenses, to the number of business tax payments required annually, to the time required for customs clearance, to the strength of creditor rights based on standardized criteria.

Countries participating in the agreement could collectively set standards for such indicators using international norms. To choose norms, they might begin by considering existing best practice in the region, or practice in East Asia, Europe, or the member countries of the Organisation for Economic Co-operation and Development (OECD).

The aim would not be to impose uniformity on tax and regulatory systems but rather to promote adherence to a universally applicable set of principles such as:

- Simplification. Systems should be as simple as possible in terms of the numbers of steps, documents, and approvals needed.
- Transparency and use of computerized systems. Regulations, documents, forms, and procedures should be standardized and published on websites, along with the authorities responsible for decision-making and enforcement. Online filing, applications, and approvals limit discretion and scope for corruption.

7. Recent criticism of the World Bank's *Doing Business* indicators has focused on measurement issues, differences of view on regulatory benefits, particularly for labor regulation, and the need to avoid downplaying the significance of other investment climate factors like macroeconomic and political stability. These are important issues, but the indicators remain useful for the purpose of setting common microeconomic standards, especially as measurement problems are addressed by the World Bank.

- Reduction of direct costs and fees. Fees charged for procedures and approvals should be kept as low as possible and made transparent.
- Time limits. Reasonable limits should be set on the time needed for approvals and decisions.

The World Bank's annual *Doing Business* reports demonstrate that reforms consistent with these principles are well within the reach of both low- and middle-income countries. The gains may be very large indeed. When Azerbaijan, the world's top *Doing Business* reformer for 2007/08, halved the time, cost, and number of procedures to start a business, business registrations shot up by 40 percent in the next six months.[8] Cross-country studies suggest that major and comprehensive improvements in developing country regulatory quality could boost per capita annual growth rates by around 2 percentage points.[9] And a better regulatory environment would likely substantially boost the growth response to lower trade barriers.[10] A regional investment standards agreement would therefore complement and expand the benefits of bilateral and sub-regional trade agreements.

BEYOND RECIPROCITY

Experience with trade agreements demonstrates that regional and multilateral agreements can help drive reform and increase its benefits. They can lock in reform. They can spur countries to mobilize the machinery of government to strengthen implementation. And they can better inform investors of policy progress, given the transparent negotiation process. Further, they give private sectors a vehicle for lobbying their governments.

This approach shares these benefits, but it would depart from the reciprocal logic of trade agreements. Trade agreements involve an exchange of concessions; that is, countries lower their barriers to imports in return for reciprocal reductions in barriers to their exports. Under this approach, countries' self interest and collective interest merge. Good region-wide standards would benefit the home country's firms, foreign firms investing in the home country, and home country firms investing in the region. Positive externalities accompany improving tax and regulatory environments as a region or multilaterally. Recognition of such benefits led Europe to move beyond reducing trade barriers to harmonizing systems. And it led financial regulators to agree on common capital adequacy standards in the Basel Accords. Coordinated improvements in microeconomic conditions of the sort that could be achieved by this kind of agreement could spur accelerated development in this hemisphere of the intra-industry supply chains that have driven and spread growth in East Asia. And faster invest-

8. World Bank 2008a.
9. *See*, for example, Djankov, McLeish, and Ramalho 2006; Loayza, Oviedo, and Servén 2008.
10. *See* Bolaky and Freund 2004 and Haar and Price 2008, chapter 13.

ment-led growth in the neighborhood pulls others along; growth is not a zero-sum game.

WHAT KIND OF COUNTRIES MIGHT PARTICIPATE?

Countries interested in joining such an effort might be motivated by some of the following considerations. They would likely:

- have large informal sectors,
- be interested in expanded regional production chains,
- want to promote increased FDI, especially in manufacturing and services,
- benefit from an external reform driver,
- seek to forestall a race to the bottom.

The first attribute applies to most of the region. The second may be of particular interest to Central America, though countries like Brazil and Mexico whose companies are increasingly interested in outward investment may also be interested. The third applies to most countries, while the fourth may apply more to small countries than to large ones. The last perhaps applies most to the United States and Central America.

FOSTERING COMPLIANCE

Once participating countries agree on standards, they could then decide whether to pursue agreement on a system for promoting compliance with agreement commitments. Participating countries could consider a gamut of soft to hard options, ranging from transparency to peer review to arbitration options for investors and states. The simplest and least intrusive approach would be to construct a process for regular national or third-party reporting on country progress. Annual report cards could be published with the agreed standards and each country's actual performance. A notch up on the surveillance scale would be to institute a system of peer review. Countries could gather regularly to discuss each other's progress and perhaps issue assessments. The most ambitious approach would provide recourse to an arbitration process to investors that allege failure by a state participating in the agreement to comply with agreed standards. This process could serve domestic as well as foreign investors if consistent with domestic law. In cases where states do not honor arbitration judgments, foreign investors could request their home countries to pursue state-to-state arbitration as a backup means of promoting compliance.

POSSIBLE INCENTIVES TO PARTICIPATE

Transition periods and capacity-building assistance. Generous transition periods and ample technical assistance could be offered to countries committed to meeting agreed standards. It would be desirable to set relatively high performance standards but give countries that initially fall short the time they need to build the capacity to meet them. (It might also make sense *to give countries some degree of choice in deciding whether to commit to all or some significant part of agreed standards. Wide differences of views on labor regulation, for example, may prevent some countries from making commitments in this area.) During the transition period, countries should be assisted with the difficult task of strengthening their regulatory, policy, and legal institutions and systems. As this technical assistance would be directed at clearly defined goals (meeting specific agreement standards within a specified time frame), recipient countries would be likely to ensure that it is productively used. The assistance could be provided by participating countries that already meet the standards, by international financial institutions, or both.*

Streamlined access to multilateral development bank funds for infrastructure and SME financing. Countries that apply these standards would improve their investment climates and thereby lower risks to investors, including the private sector investment arms of multilateral development banks (MDBs). MDB private sector investment is often slowed by lengthy project analysis that must take into account a range of macroeconomic and microeconomic policy risks, as well as operational risks. Participation in such an agreement might make it possible for MDBs to move forward more quickly, as well as raise their estimates of risk adjusted returns for some projects, thereby making them eligible for investment.

Access to Arbitration. In the context of multilateral agreements, enforcement capability is probably valued as much as the quality of commitments. Firms' interest in having their governments participate in such an effort would be heightened by the inclusion of arbitration rights. Governments themselves would likely be conflicted—reluctant to submit themselves to arbitration while interested in the option of using it to promote compliance by other governments that fail to honor commitments.

LAUNCHING DISCUSSIONS

To launch this effort, interested countries could begin by calling for exploratory discussions to define options for an agreement scope and structure that could generate broad support. Such a call might logically come from those already focused on investment reforms but interested in expanding the benefits. Colombia, the Dominican Republic, Guatemala, Mexico, and Peru, for example, have been named among the top ten global reformers by the World Bank in its *Doing Business* reports, while Chile ranks 40 in the world on the ease of doing business, the highest in Latin America.[11]

Regional institutions could host exploratory discussions. Such discussions should involve both governments and business as vital and logical partners in this effort. The Inter-American Development Bank, aided by the World Bank, could provide essential technical input as it did in the

11. World Bank 2008a.

early days of the discussions on the Free Trade Area of the Americas. The United States, Brazil, and Mexico could play key roles by signaling their renewed commitment to hemispheric economic cooperation and by encouraging support from regional institutions. The United States could take the lead in mobilizing aid to help countries build capacity to meet standards.

The Summit of the Americas next year provides an opportunity for leaders to support work on a standards agreement among interested countries. In the likely absence of near-term agreement on resuming FTAA negotiations, pursuit of a regional investment standards agreement could supply one possible new way forward for regional economic cooperation in this hemisphere.

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